Internal Revenue Service

memorandum

CC:TL
Brl:CEButterfield

date: JUL 22 1988

to: Regional Counsel, Southeast CC:SE
Attn: [redacted]

from: Director, Tax Litigation Division CC:TL

subject: [redacted]

This is to confirm the conclusions reached from the meeting on July 12, 1988, with [redacted] and attorneys for [redacted], [redacted] of your office, Mr. Horan and Ms. Butterfield of this office and members of the Corporation Tax and Interpretative Divisions.

ISSUE

The issue over which the meeting was called was the correct placed in service date for Plant [redacted]. 0048-0200

CONCLUSION

By memorandum dated May 11, 1988, we expressed our conclusion to you that the correct placed in service date for the plant was [redacted], the date on which the plant was synchronized into the main power grid of the [redacted]. Nothing that transpired at the July 12, 1988 meeting compels us to alter this conclusion.

FACTS

[redacted] attempted to draw our attention to several facts which he believed indicated that the position taken in this case by the Service is inconsistent with previous litigating positions we have taken. In particular [redacted] emphasized the seriousness of the defects with the boiler and stack, all of which transpired or caused shutdowns after the date of synchronization. The need to install baffles in the boiler was made to appear particularly significant. [redacted] also raised the issue that by the agreement between [redacted] and [redacted], [redacted] was not entitled to payment for electricity during the testing period, and did not receive any payments until

after the commercial operation date. He suggests that the plant cannot be considered to be placed in service for this taxpayer ([redacted]) until it was legally entitled to generate revenues from the use of the plant.

LEGAL ANALYSIS

[redacted] brings up a number of arguments that he feels should delay the placed in service date of the plant until commercial operation. He indicates that the plant never appeared to be in a state of readiness until after the vibrational problems with the boiler were discovered and repaired, which did not occur until 12 days before the commercial operation date. He states that it was within the contemplation of all the parties that the original synchronization and high pressure testing of the boiler were solely for the purpose of finding out whether this particular boiler was in the 10-15% catagory of boilers requiring baffles to reduce vibrations. Although [redacted] states that these assertions can be readily documented, he has not produced the documentation thus far.

The other two main flaws experienced after synchronization were not greatly emphasized by [redacted]. It has been suggested to us by Corporation Tax that you investigate whether or not the locking bolt that sheared was designed to do so -- shear pins are not uncommon in the design of plants such as this one. Were it to have sheared by design there would be even less weight to the argument that this was a structural defect. As to the difficulties with the stack, these may have been caused by shutting the plant down in cold weather -- a fluke development due to sudden temperature change. Our expert should be able to investigate both of these possibilites with you.

We would also suggest that you discuss the process by which commercial operation dates are usually selected with our expert. These dates are subject to great manipulation by the regulatory commissions, because they have more to do with the ratemaking procedures than with the mechanical readiness of the facility. Indeed, some plants have been phased into the rate base, with different costs being declared commercially operable at different dates. This would assist in rebutting [redacted]'s arguments that the commercial operation date is a more rational date than the date of synchronization.

Generally it became clear in the course of the meeting that [redacted] is arguing for a hindsight test in determining when a plant is placed in service. We must emphasize that the placed in

service date at issue is the one that applies for purposes of the safe-harbor leasing provisions. Temp. Treas. Reg. § 5(c).168(f)(8)-6(b)(2) provides that placed in service for these purposes means "placed in a condition or state of readiness and availability for a specifically assigned function. If an entire facility is leased under one lease, property which is part of the facility will not be considered placed in service under this rule until the entire facility is placed in service." The brevity of the 90 day window indicates that for purposes of this provision there is not the same flexibility that exists in applying the various depreciation conventions to property. A more specific date is intended. We believe that [redacted]'s reliance on the placed in service conventions for depreciation is somewhat misplaced.

As we have expressed it to you before, our position is that the placed in service date depends on four factors: control (meaning title and risk of loss); synchronization into the main power grid; permits and licenses; and critical testing. We are convinced in this case that all four factors were in place when the plant was synchronized. [redacted] will argue that the entire facility was not placed in service until it was tested as a unit. He may look for support to Treas. Reg. § 1.103-8(a)(5), which states that the date on which an entire facility is placed in service "shall not be earlier than the date on which - (a) It has reached a degree of completion which would permit operation at substantially the level for which it is designed, and (b) It is, in fact, in operation at such level." This emphasis on the entire facility begs the question. These regulations are designed to establisn a placed in service convention for the issuance of industrial development bonds, and therefore can be of limited usefulness in the safe-harbor leasing context, where very different purposes are at work. Moreover, it is of no help to say that placed in service means placed in service as an entire unit, because our position is that a plant is in fact placed in service as an entire unit when it meets the above-mentioned tests.

[redacted] urges a bright-line test, that placed in service go by the date of commercial operation. We have never taken the position that this date is decisive for these purposes. Moreover we have rejected a bright-line test based on the synchronization date. The determination to be made is one of facts and circumstances, and is based on when the parties intend that the plant be made available for its assigned function. In this case the function is the generation of electricity, and to everyone's belief the plant was ready to perform when it was synchronized. The subsequent revelation of latent defects, and the continuation

of testing after that date will not impede its effectiveness as the placed in service date.

We do not believe that the case of Piggly Wiggly Southern, Inc. v. Commissioner, 84 T.C. 739 (1985) is of any great help to petitioner in this case. In Piggly Wiggly there were two separate placed in service issues being considered. One was the placed in service date of new equipment in remodeled stores. The other was the placed in service date of equipment operated in new stores. Respondent had taken the position that equipment installed in the remodeled stores could not be placed in service until the stores officially reopened, in spite of the fact that the stores actually closed for only one day for their grand reopenings, and had been open and in operation continually up until that point. The court found that the equipment had been installed and used in the year of purchase, and found that it had been placed in service in that year, before the reopening.

On the other hand, the court found that the placed in service date for equipment in new stores should be tied to the opening dates. The court found that the opening of these stores was entirely within the control of the taxpayer, and that they should not be allowed to obtain the benefit of earlier deductions, when the income the expenses were incurred to generate did not begin until the following year, due solely to the decision of the taxpayer not to open the doors until that time. Thus, this aspect of the holding in Piggley Wiggley can be said to stand for the proposition that property will generally be considered to be placed in service when it is ready to fulfill its assigned function (the function of a grocery store -- to sell groceries --is readily distinguishable from the function of a power plant -- to generate power), but that this date cannot be artificially delayed by factors within the control of the taxpayer. While we would not assert that the breakdowns were within the control of [redacted], they have some influence over the selection of the commercial operation date, and over the amount of down time they will subject the plant to in order to make the necessary repairs.

Consumers Power Co. v. Commissioner, 89 T.C. No. 49 (September 30, 1987) can also be distinguished because in that case the parties had agreed at arms length that title would not pass until pre-operational testing was complete, and they had spelled out in detail in their agreements what the definition of pre-operational testing was to be. Unless [redacted] can produce the proof he spoke of that will demonstrate that the pre-commercial operation runs by the unit were merely a testing mode,

to run the boiler at high pressure, Consumers Power will not support the date for which he is arguing.

The sections of Respondent's Reply Brief in Consumer's Power to which [redacted] alludes in his memorandum do nothing to overcome the obvious distinction between these two cases. The paragraphs on which he relies only further discuss the fact in that case that title did not pass to the taxpayer, under the express agreement between the parties, until specified pre-operational testing was completed. In this case, although [redacted] purports to be able to do so, he has presented no evidence that would establish an intention by the parties to synchronize the plant into the power grid solely for the purpose of testing the boiler under actual operating conditions. The conclusions in the reply brief expressly rely on the terms of the agreements between the parties. Were there similar agreements in this case, we would no doubt be forced to a similar result. No such agreements have been produced, however, and we are not persuaded that any such agreements exist.

We also discussed the argument that [redacted] had no right to income from the plant before commercial operation, and therefore the plant could not be in service for [redacted]'s purposes until that time. Assuming this statement is factually correct, we do not believe that it will help [redacted]. The assigned function of Plant [redacted] was to generate power, and to exist as a current supply for [redacted], and a reserve supply for [redacted]. The financial arrangements between the parties were intended to shift the expenses and revenue to [redacted] to the greatest extent possible without disqualifying [redacted] for its [redacted] loan. They should not be imbued with sufficient substance to control the placed in service date for purposes of validating the safe-harbor leases.

In short, malfunctions are likely to occur at any point in the operation of a power plant, and the testing of the plant may continue for many months even beyond commercial operation. The result for which [redacted] argues could be extended so that any time a taxpayer knew of a possible defect that had a 15% likelihood of developing within months or years of start-up, the

facility would not be placed in service until the defect had been made manifest and corrected. The revenue rulings already cited to you lend no support to such a position.

If you have any questions, or if we may be of assistance, please call Ms. Clare E. Butterfield at (FTS) 566-3442.

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